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Working Paper

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Kiel Working Papers, No. 640

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Suggested citation: Agarwal, Jamuna Prasad (1994) : Impact of Europe Agreements on FDI in developing countries, Kiel Working Papers, No. 640, http://hdl.handle.net/10419/46750

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Kiel Working Paper No. 640

Impact of "Europe Agreements" on FDI in Developing Countries

by

Jamuna Prasad Agarwal

July 94

Institut für Weltwirtschaft an der Universität Kiel
The Kiel Institute of World Economics

ISSN 0342 - 0787

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IMPACT OF "EUROPE AGREEMENTS" ON FDI IN DEVELOPING COUNTRIES*

I. INTRODUCTION

Since the collapse of their planned economies, the Central and Eastern European countries (CEECs) have entered into varying kinds of trade and investment facilitating agreements with the European Union (EU). Most wide-ranging of them are the association agreement with Bulgaria, Hungary, Poland, Romania, Czech and Slovak Republics. These agreements envisage a full membership of these countries in the EU after a certain convergence of their economies towards Western Europe. Therefore, they are called Europe Agreements (EAs). Moreover, the underlying vision of the EU and EAs is of one unified Europe. The EAs grant preferential access in the EU to goods produced in the associated countries. These preferences are higher than those in other association agreements with developing countries [Hiemenz et al., 1994]. Therefore the latter are worried that the access of their goods to the EU may be impaired. Trade is usually correlated with FDI. Because of this nexus with trade, EAs may affect also the flows of FDI in developing countries. This is suspected especially in the case of outsourcing FDI, where firms from developed countries invest abroad to take advantage of lower unit labour costs and relatively liberal environmental regulations in the host countries. In this respect, the above six associated European countries (EA-countries) offer similar locational advantages to investors as many of the developing countries. In addition to this, transport costs from the EA-countries is likely to be less than from most of the developing countries to the EU. Culturally too European firms may feel more at home in investing in the EA- than developing countries. Thus the latter seem to have some reasonable grounds for apprehending a diversion of FDI to the former. Low unit costs of labour or environmental protection, cultural similarities, and preferential trading facilitate FDI between the related countries, but need not necessarily divert FDI from third countries. This paper attempts to evaluate the pros and cons of investment diversion hypothesis in this context.

This hypothesis is, however, not quite new. As soon as the Treaty of Rome was signed, Latin American and Asian developing countries expressed their concern about the association of the former Belgian and French colonies with the EU and its likely adverse affects on their exports. FDI was considered in those days not as

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* I am thankful to Ulrich Hiemenz for helpful comments on an earlier draft of this paper, and to Susanne Tobias for helping in the collection of data. Thanks are due also to László Csaba (Budapest), Agnes Ghibutiu (Bucharest), Tudor Gradev (Sofia), Jana Sereghyová (Prague) and Jósef Misala (Warsaw) for providing with national statistics on FDI.

important. Similar apprehensions were raised when the number of associated countries increased due to the EU membership of the UK in 1973, and when Greece (1981), Portugal and Spain (1986) joined the Community. By the 1980s, fears of investment diversion assumed greater importance. Also the varying kinds of trade or cooperation agreements with various Mediterranean countries [Hiemenz et al., 1994] inflamed the discussion on the suspected investment diversion to the associated countries. In many of these cases, trade and investment between the countries concerned did increase, but it could not be said to have occurred at the cost of third countries. In the case of the EA countries, developing countries are, however, more concerned because most of the former have a common border with the existing or future EU, and want to become full fledged members. This should strongly encourage European firms to include these countries in their global strategies. But this need not necessarily be at the expense of developing countries. In order to examine this, at first the main features of the EAs are analysed. It is followed by a discussion of the relation between preferential trade and FDI. Later, an examination of the data on FDI-flows should enable to detect if a diversion from developing countries has occurred. If not, what are reasons for this in spite of a high popularity of investment diversion hypothesis, and whether they are generalisable?

II. THE EUROPE AGREEMENTS

The EU entered into Europe Agreements in December 1991 at first with Czechoslovakia, Hungary and Poland. Later they were signed with Bulgaria and Romania, and extended to the two successor states Czech and Slovak Republics. In its summit meeting in June 1993, the EU further agreed to shorten the transitional periods envisaged in these agreements for removing restrictions on certain imports from the EA-countries, and allow all of them to become full members depending on the progress of their economic and political conditions. Strictly speaking each of the EAs is an independent agreement. But they differ only in detail. Therefore, they are treated here as a group. The main relevant features of these agreements are:

- Removal of tariff and non-tariff barriers on most manufactured imports from the EA-countries in the EU. In the case of agricultural goods, coal, iron and steel, and sensitive manufactures including some items of chemicals, furniture, leather goods, footwear, glass, vehicles, textile and clothing import barriers will be removed according to a given time schedule to avoid undue competitive pressure on domestic producers [Winters, 1993]. The concessions granted in these goods put the EA-countries at the top of preferences ever granted by the EU to outsiders including the associated developing countries [Hiemenz et al., 1994].

- The EA-countries are granted longer periods of time (upto 10 years) to introduce full access to their domestic markets for goods produced in the EU in order to allow domestic producers to prepare themselves for full scale competition from powerful EU-firms.

- The associated countries will receive financial assistance (credits and grants) from European Investment Bank and under PHARE program to finance their developmental expenditure. In addition to it, technical help will be extended to build up a state-of-the-art administration in various fields. The aim of this technical cooperation is to enable the associated countries to adjust their economic system towards the EU so that they can become full members in future [Langhammer, 1992].

Thus, there are three important features of new economic relations between the EU and the EA-countries which call for attention in the context of this paper. First, the access barriers for EA-countries are far lower than those for developing countries including the signatories of Lomé Convention. Second, the EA-countries are going to get relatively more financial and technical aid from the EU than any other outside recipient country. Third, investors have to reckon with an improvement of economic and social conditions in these countries, if their associated status is to be transformed into full membership of the Union in future. This means that wage costs and environmental restrictions will rise, and investors cannot assume that costs differences between the EA-countries and the EU will remain stable over time.

Points one and two should exercise positive effects on the flows of equity-capital in the EA-countries. They add to the existing "natural" locational advantages of these countries in international competition for equity capital vis-à-vis the developing countries. The existing advantages are geographical and cultural proximity of these countries to Western Europe, and availability of human capital. In addition to these, hourly wages in the EA-countries are presently very low, ranging between one-tenth and one-twentieth of those in Western part of Germany. On the one hand, this should encourage investors from the EU to establish additional production units there or relocate some of the relatively labour intensive plants from their home countries in the EA-countries. On the other hand, point three mentioned above should act as a disincentive for them in doing so, at least in those cases where the pay-off period is relatively long making development of wage costs and exchange rates unpredictable. This is particularly important for outsourcing FDI. As it is shown later, it is mainly this kind of FDI which is relevant for investment diversion effect of the Europe Agreements on third countries. But before we discuss this, a

short review of the existing evidence on the effect of preferential trading and aid on the flow of FDI from the donor to the receiving countries is in place.

III. PREFERENTIAL TRADE AND FDI

Trade preferences and complete integration tend to promote FDI. Historically, the "imperial preferences" led to high FDI inflows in the colonies from the United Kingdom. This early concentration of the economic relations continued for a long time also after their political independence. Similar is the case with France and its former colonies [Agarwal et al., 1985]. The EU enlargement towards South (Spain and Portugal) and expectations of the subsequent deepening of its internal market in 1992 were followed by rising shares of member countries in each other's FDI-outflows. The share of the EU Southern periphery in outward FDI of France, Germany, the Netherlands and the UK has increased after the former joined the Community [Agarwal et al., 1994, p. 291]. A major share of the very impressive growth of FDI inflows in Mexico comes from the USA also in expectation of the preferential arrangement between them under NAFTA [Nunnenkamp et al., 1994]. Most of the US FDI in Mexico is in "maquiladora" industries near the common border of the two countries. Two of the associated EA-countries have common borders with the EU, and others close geographical links. The preferential agreements with Mediterranean countries resulted in many cases in increased involvement of EC firms, as Joekes [1982] has shown for Tunisia and Morocco, and Pomfret [1986] for Malta. In the latter case, the timing of FDI supports its relationship with the agreement in 1970.

Preferential trading arrangement can attract FDI from third countries as well. The preferential access to the UK and French markets has led, for example, to MNC's investments in the Caribbean Banana industry [UN, 1992], Hong Kong firms have invested in textile and clothing industry of Mauritius which is associated with the EU under Lomé Convention, and goods produced and exported from there enable them to bypass the restrictions imposed under Multi-Fibre Arrangement.

Economic and technical aid also can stimulate FDI from the donor into the receiving countries. Some of the constituents of bilateral aid such as grants for pre-investment studies or financing of infrastructure required by the firms of donor countries in the host countries are directly associated with FDI-flows. Another reason for the positive relation between aid and FDI is that aid is executed often by the private firms of donor countries, and the economic relations emerging out of it between these firms and aid receiving countries may result in FDI of the former into

the latter. Furthermore, grant of aid is generally an indicator of good political and economic relations between donor and recipient countries, which are useful also for FDI flows. Some of the econometric studies [Schneider and Frey, 1985] have found aid as an important determinant of FDI inflows in developing countries. From the point of view of outflows, aid was found to have a strong influence on Japanese FDI in developing countries [Agarwal, 1986]. In other countries (Germany, UK and USA) geographical distributions of aid and FDI were not significantly correlated. Aid from the EU-members to the EA-countries is, however, a special case. Relatively large number of small and medium sized EU-firms are searching for investment opportunities in the neighbouring EA-countries. Aid together with other incentives may prove very effective in promoting their investments.

However, it is too early to look for an econometric evidence for the impact of aid or trade on FDI in the EA-countries. The first three EAs became effective from March 1992 and the data on FDI are available only upto 1993. The other two were signed even later. So the following analysis examines the data only on FDI assuming that investors tend to preempt the advantages of aid and trade preferences in their investment decisions.

IV. FDI FLOWS IN THE EA-COUNTRIES

These countries have experienced a dramatic growth of the numbers of firms established by foreign investors as subsidiaries or joint ventures with local participation since the transformation of their economies (Table 1). The total number of these firms rose in 1990 by five times the level in the preceding year and then by fourfold in the following two years. In 1993 the growth was lower heralding a gradual normalisation of registration of new foreign investment enterprises (FIEs) in the EA-countries.

The value of FDI in the EA-countries has risen less dramatically. It increased from less than half a billion US$ in 1989 to more than three billion US$ in 1992. Last year it declined to two and a half billion US$. Nonetheless, it was more than five times the amount received by them in the beginning of the transformation process in 1989. This is quite an impressive growth in view of the political and economic instabilities prevailing in these countries. It compares well with the strong growth of FDI in China after the liberalisation towards the end of the 1970s. Both the cases have in common that many of the investment projects are undertaken by or in partnership with expatriate nationals of the recipient countries, and can be

interpreted partly as a return of entrepreneurial "flight capital" after the opening of economies for private initiative and performance.

Table 1 - FDI in EA-Countries, 1989-1993 (Numbers and Mill. US$)

	Number of registered firms with foreign participation at year end					Net inflow of FDI, Mill. US$				
	1989	1990	1991	1992	1993	1989	1990	1991	1992	1993[a]
Bulgaria	30	140	900	1200	2300	-	4	56	42	44
Ex CSFR	60	1600	4000	5995	9350	257	207	600	1103	661
Hungary	1357	5693	9117	13318	21468	187	311	1462	1479	1200
Poland	911	2799	4796	10131	15053	11	89	291	678	580
Romania	5	1501	8022	20684	29115	-	-18	40	77	50
Total	2363	11733	26835	51328	77286	455	593	2449	3379	2535

[a] Preliminary estimates.

Source: IMF [various issues]; Agarwal et al. [1994]; CEC [1994]; UN [various issues].

The reasons for a stronger growth of the registered number of FIEs than of the value of FDI are manifold. First, many of the registered FIEs do not materialise. Specially in the initial stages of economic development, the ratio of operational to registered FIEs tends to be low. In the EA-countries, it varied between 40 per cent (ex-CSFR) and 80 per cent (Hungary) at different points of time since the transformation began [OECD, 1993]. As compared to the registered numbers of FIEs, the values of FDI here are those which have already been brought into the host countries. Second, even in the case of FIEs which become operational, there can be long time lag between registration and final inflows of capital. The number of FIEs in the EA-countries, for example, increased in 1991 by five times the number in previous year, but the corresponding jump in FDI values though not as strong, came a year later in 1992 (Table 1). Third, most of the FIEs are of small or medium size entailing investments between US$ 45000 and US$ 1.5 Mill. [UN, 1992]. Many of the MNCs have opened representative offices in these countries to promote trade and seek investment opportunities after the removal of the iron curtain. These representations are often counted as FIEs but involve very little capital import. The bigger investments such as in automobile industry (e.g. Fiat SpA in Poland, Ford Motor Company and General Motors in Hungary, Volkswagen AG in ex-CSFR), or in electrical sector (Elektrolux and General Electric in Hungary), which involve bigger capital imports, are not as frequent, and have longer gestation periods.

V. DIVERSION OF FDI FROM DEVELOPING COUNTRIES, IF ANY

Now the question arises whether the strong growth of FDI in the EA-countries has occurred at the cost of developing countries. One way of answering this question is to examine the development of their shares in global flows of equity capital, which is given in Table 2. Since 1989, the share of developing countries in the global inflows of FDI has more than doubled rather than decreasing. So from this point of view, it is impossible to think of a diversion of investible resources from them. Even at the disaggregated level, in none of the five developing regions FDI inflows have receded between 1989 and 1992 to match the rise in the EA-countries. The decline of 0.1 per cent in the share of Middle East is too little to draw any conclusion in this respect. The major decline has taken place during this period in the inflows of FDI in the US. But here also, it would be unrealistic to think of an investment diversion from the US to the EA-countries. First, there is no meaningful competition between them for FDI flows. Their locational conditions are generally quite different. Second, the decline of the US share in global FDI flows from 35 per cent in 1989 to 2 per cent in 1992 was too large compared with the rise of 2 per cent in the share of the EA-countries. The US share declined due to the strong recession in their domestic market.

Table 2 - Regional Shares in World Inflows of FDI, 1980-1992 (Mill. US$ and percentages)

	1980-88 (annual average)	1989	1990	1991	1992
World	74634	192361	203969	158350	149928
of which					
Industrial Countries	78.2	86.6	84.6	75.0	66.4
EU	30.5	42.1	49.0	45.9	52.3
Spain and Portugal	4.2	5.3	8.1	8.2	6.6
USA	39.2	35.3	22.1	15.1	1.6
Japan	0.4	-0.6	0.9	0.9	1.8
EA-Countries[a]	*	0.2	0.3	1.5	2.3
Developing Countries[b]	21.8	13.2	15.1	23.4	31.1
Africa	1.6	1.5	0.5	1.5	1.8
Asia	7.9	7.1	9.0	12.9	18.4
Europe (Cyprus, Malta, Turkey)	0.3	0.4	0.4	0.6	0.6
Middle East	5.1	0.7	1.5	0.6	0.6
Latin America	6.6	3.5	3.8	7.9	9.7

* Less than one tenth of a percentage point.

[a]Figures for these countries do not necessarily correspond to IMF data. - [b] Excluding Eastern and Central European countries.

Source: IMF [various issues]; Agarwal et al. [1994].

The concern of developing countries about competition for FDI flows is also based on the high rate of growth of foreign equity capital in the EA-countries since the beginning of their transformation process. Within five years, they increased more than fivefold. However, this is primarily a result of very low values of FDI flows in the starting period. After some time, their growth rates are likely to flatten, which will provide a better scope for comparison between the EA-countries and others. Moreover, most of FDI inflows in the EA-countries are invested either in relatively small units or used for acquisition of existing state enterprises. In both of these cases, the chances of investment diversion are rare. Such investments are very likely an addition to total flows and not a diversion from any other region or country. Some of the investments in smaller units in border areas, e.g., from Germany into Czech Republic may be at the cost of former's domestic capital formation but not to the disadvantage of developing countries. Distance is a limitational factor in the mobility of smaller firms where management rests on very few persons mostly from the same family. They may move to a neighbouring country to take advantage of lower cost of production, but usually not to another country at a greater distance associated with higher risk perception.

The experience with the widening of the EU to Greece (1981), Portugal and Spain (1986) or its deepening through the Single European Act in 1987 also does not allow to apprehend any meaningful diversion of FDI from the developing countries. The fall of their share in global FDI flows thereafter (Table 2) was apparently not associated with the numerical or qualitative changes of the EU. More than half of the loss of developing countries' share in 1989 and 1990 compared with pervious period (1980-88)[1] was accounted by the Middle East where Saudi Arabia is the main player. FDI flows to this country are very volatile owing to large intra company transfers of loans of MNCs. The fluctuations of these loans are not related with the said changes in the EU. If Saudi Arabia is excluded from global FDI-flows, the loss of the shares of the Middle East and developing countries becomes much less dramatic. The other two important countries of this region are Egypt and Israel. They have cooperation and free trade agreements with the EU. Thus, drops in their shares are related more with their economic and political uncertainties than with the changes in the EU and its membership. The other important region whose share declined during the 1980s is Latin America. Here also it is the unfavourable domestic economic and political conditions, and not the creation of the Single Market or its earlier southern extension which were responsible for the decline of its share in global FDI flows. During this period Latin American economies were generally

[1] A comparison with the early years of 1980s yields a stronger decline of their share, but the analysis remains the same. See Agarwal [1994] where the effect of the EU deepening is discussed in greater details.

characterised by high international indebtedness, failure to service foreign loans, high inflation rates, poor growth prospects and huge budget deficits. This was in marked contrast to the 1970s, when Latin America registered high growth rates attracting relatively impressive amounts of FDI. Persistent debt problems impaired the creditworthiness of Latin American countries not only for foreign loans but also for FDI. Moreover, the trend of declining Latin American share in global FDI flows can be traced back to the early 1980s, i.e. long before the said changes in the EU. This trend has now been reversed primarily as a result of improvement in their economic conditions [Nunnenkamp, Agarwal, 1993].

Strongest concern about FDI diversion due to the EU deepening and extension is expressed by the Asian developing countries. Many of them have hosted foreign firms producing goods for foreign markets. They fear that their cost competitiveness may be impaired by the trade preferences granted to the EA-countries. In connection with the EC 1992, Page [1991] found Asians as the only group of developing countries who could have faced a net adverse effect on their exports to the member countries. Due to its link with trade, FDI appeared to draw a similar negative impact [Kreinin and Plummer, 1992]. However, except for a minor reduction in 1989, they have continually raised their shares in global FDI flows. Furthermore, the contribution of FDI to domestic capital formation of most of the Asian developing countries has been increasing since the mid-1980s [UN, 1993]. Thus, there is no evidence of a diversion of FDI from this region towards the associated European countries either before or after the demise of command economies.

Another method of analysing the effect of the EAs on developing countries is to draw on the experience of the Southern periphery of the EU. It was integrated already in the 1980s, and the Iberian countries recorded high growth of FDI after they joined the EU in 1986. However, the growth rates of FDI inflows in the Southern periphery and in the rest of the EU during 1986-90 compared with 1980-85 were the same [IMF, various years]. Therefore, it is much more likely that the Southern periphery benefited from the creation of additional FDI stemming from strong economic growth in the EU than from an investment diversion from developing countries, which should have resulted in an additional growth of FDI inflows in the Southern periphery. Furthermore, the growth of FDI inflows in Greece, which has no common border with any of the EU members, was considerably lower (9 per cent per annum) than in Iberian peninsula (35 per cent per annum) during 1980-85 and 1986-90. The share of the former in world inflows of FDI rather declined from nearly one per cent to half a per cent [IMF, various years] showing that integration in an

economic union such as the EU is not a sufficient condition to raise the inflow of FDI in a country.

In Portugal and Spain the highest growth was registered for their mutual FDI flows compared with those from other countries [OECD, 1993]. Removal of restrictions on movements of goods and factors of production between bordering countries generally leads to increased FDI flows. This *common-border effect*, is generally an investment creation and not a diversion from third countries resulting from economic integration of the neighbouring countries. Greater the difference between economic development of integrating countries, higher the flow of FDI from the more to the less developed bordering economy. For example, French FDI in Spain increased since 1986 more than those from Germany, Japan, the UK or the USA, and this was not at the cost of developing countries. This is obvious from the fact that Spanish share in French FDI outflows rose from 5 per cent to 18 per cent between 1982-85 and 1986-91, whereas developing countries' share declined from 4 per cent to 3 per cent [OECD, 1993]. An increase of 13 per cent, though caused by the integration of Spain in the EU and by the Single Market Programme, cannot be assessed as diversion of French FDI from developing countries when their share dropped by only one per cent during the same period.

In the EA-countries, FDI comes mostly from the bordering EU or EFTA countries (Table 3). More than three fourths of FDI stock in Bulgaria are from Greece. The latter is otherwise an insignificant international investor. Since it does not play any role for FDI in developing countries or elsewhere, its FDI in Bulgaria is largely a case of investment creation emanating from liberalisation of economic relations across their borders. Similarly in Czech and Slovak Republics as well as Hungary most of FDI has originated from Austria and Germany. In Romania, which has no common border with any of the EU members, FDI is widely distributed among France, Italy, the UK and the USA. However, liberalisation of trade and factor mobility is only an enabling but not a necessary or compelling condition for increased flows of FDI between neighbouring economies. Poland has signed Europe Agreement and has a common border with Germany. But German investors have yet been reluctant to undertake large investment there. The overriding role in Poland is played by the US investors. Preferential access of a country to a common market is a good incentive for the latter's investors to invest in the former. It does usually promote FDI, especially if both of them have a common border as also in the case of Mexico and US [Nunnenkamp et al., 1994]. But the incentive provided by economic integration may also be frustrated by other factors. For example, the Canadian share in the US outflows of FDI decreased instead of increasing since the Canadian-US Trade Agreement (CUSTA) in 1989 [USDOC, 1993]. Freedom of trade from tariff and

non-tariff barriers stimulated some of the US firms to exploit scale economies of their home production bases and to withdraw from their direct involvement in Canada. Falling transport and communication costs, and converging demand patterns between the two countries facilitated this process further. The case of the EA-countries is, however, quite different. The process of the EU investments in these countries is in the initial stage, and there is quite a difference between development levels of the two sides. So the growth of the EU-FDI in the EA-countries is expected to continue for long. But this need not affect the flow of equity capital to developing countries. The forecasts for the near future (upto 1995) have projected high growth of FDI in developing countries of Asia and Latin America.[2]

Table 3 - Clusters of FDI (Stock) in EA-Countries (latest available[a], per cent)

	EU	EFTA	USA	Other	Major Source Country
Bulgaria	94.0	3.0[b]	2.0	1.0	Greece (77%)
Slovakia	34.3	29.3[e]	13.6	22.8	Austria (25%) Germany (22%)
Czech Rep.	54.6[d]	10.5[b]	27.9	7.0	Germany (31%) USA (28%)
Hungary	41.0	14.0[c]	29.0	16.0	Germany (20%) Austria (14%)
Poland	30.1	16.8	43.7	9.4	USA (44%) Italy (11%)
Romania	61.8	4.2	10.0	24.0	UK (14%) Italy (13%) France (11%) USA (10%)

[a] Bulgaria: May 1993; Slovakia, Sept. 1993; Czech Rep. Jan. 1994; Hungary: Aug. 1993; Poland: June 1993; Romania: 27 Sept. 1993. - [b] Austria and Switzerland. - [c] Austria only. - [d] Belgium, France, Germany, and Italy. - [e] Austria and Sweden.

Source: UN [various issues]; PlanEcon [1993]; NBR [1993]; Figyelö, 37.1993.

The above global view does not, however, exclude the possibility of FDI diversion in individual cases at micro level. Specially in labour intensive industries such as leather, textile and clothing, the EA-countries attracted European outsourcing FDI even before the demise of their socialist regimes. In addition to their low labour costs, now they have a better access to the EU market than developing countries. So relatively more cost-oriented investors from Europe should tend to prefer production sides in the EA-countries rather than in developing countries which

[2] Under some favourable scenarios, FDI may grow in Africa also - contrary to the 1980s - with a faster rate than in these two continents [UNCTAD, 1994].

are located at greater distance involving higher transport costs. How far this will actually take place remains to be seen. For the present, there is hardly any evidence that FDI has been diverted from them to the EA-countries. The sparsely available sectoral data on FDI in these countries indicate only marginal shares of these industries (Table 4).[3] Most of FDI is in industries and services targeting at the host markets, and thus less sensitive to investment diversion.

Table 4 - Sectoral Structures of Foreign Direct Investment (Stock) in EA-Countries (latest available,[a] per cent)

	Bulgaria[c]	Hungary	Poland	Slovak Republic	Czech Republic[e]	Romania
Primary Sector	0.7	2.1	...	1.1	...	7.9
Agriculture	0.7	0.8	...	0.1[b]	...	4.1
Mining and quarrying	0.0	1.3	...	1.0	...	3.8
Manufacturing Sector	13.3	55.5	75.5	50.0	66.6	39.1[f]
Food	...	17.8	23.0	...	9.8	9.4
Textiles, leather and wearing apparel	...	2.9	6.0	...	...	...
Wood, paper and printing	...	3.7	28.0	...	...	...
Chemicals	...	6.6	11.0	...	6.0	...
Non-metallic prod.	...	4.8	...	...	...	...
Basic metals and metal prod.	...	4.3	...	...	...	...
Machinery and equipment, n.e.c.	...	14.6	...	...	...	...
Electrical equipment	3.5	...	7.5	...	...	3.8
Transport equipment	...	...	...	...	20.3	...
Services Sector	86.0	42.4	...	48.9	27.9	53.0
Construction	2.2	4.0	2.6	3.1	12.8	4.8
Trade	61.9	12.4	15.7	29.2	5.0	21.2
Hotels and restaurants	8.9	3.2	1.3	0.2	...	8.8
Transport	2.2	1.9[d]	2.6	0.6	...	8.0
Financial intermediation	2.4	11.3	0.2	7.9	10.1	3.0

[a]Bulgaria: Aug. 1993, Poland: 1992 (preliminary), Hungary: June 1993, Czech Rep.: 1993, Slovakia 1992, Romania: 20.3.1990-20.10.1993 (tentative). - [b]Including fishing. - [c]Number of FIEs. - [d]Incl. telecommunications. - [e]Undistributed: 5.5 per cent. - [f]4.1 per cent light industries.

Source: UN [1992]; UN [various issues]; FTRI [1993]; Romanian Development Agency [unpubl.]; FIC [1993].

VI. LIMITED SCOPE FOR FDI DIVERSION

The foregoing analysis of the existing data does not reveal any FDI diversion. Now the question is what is the future scope for such an investment diversion? In order to deal with it a sectoral differentiation is in place. An exceedingly large proportion of FDI in developing countries is in natural resources, services and industrial complexes to meet the local demand. This kind of FDI is location specific, and

[3] The industrial classification underlying the national FDI data differ. Therefore, the scope for international comparison is limited.

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cannot be diverted to the EA-countries. The remaining FDI in footloose industries, which is undertaken by MNCs due to relatively lower unit costs of labour and environmental safeguards in developing countries is internationally mobile. It can be diverted to the EA-countries because of their matching cost advantages and better access to the EU internal market. But the share of footloose industries in global FDI is certainly very very low, though no precise statistical estimates are available.

In natural resources, the EA-countries do not seem to compete with developing countries for FDI. So the question of FDI diversion in this field does not arise. Even otherwise, investments in this sector are highly locational, and cannot be diverted from the one to another country unless the latter has the same or better quality of a particular natural resource to offer under competitive conditions. Most of FDI in the primary sector of developing countries is not likely to be negatively affected by the association and later the integration of the EA-countries in the EU. The primary sector has so far played a minor role in attracting FDI in these countries (Table 4). But for many developing countries, primary sector plays an important role in attracting FDI [Agarwal et al., Table 7.1]. However, its importance is declining both from the point of view of host and home countries. Its share in the outflow of FDI, for example, from the EU-countries declined from 22 per cent in 1984-85 to 6 per cent in 1990-91 [ibid., Table 4.1].

In services sector, production and consumption occur generally within the same country or region. In most of the cases (construction, real estate, trading, transport, storage, communication, finance, insurance, etc.) firms seeking business in the developing or the EA-countries will have to make direct investments in the respective market places. In these cases mobility of investors between different host countries is rather limited, if not absent. The only conceivable case is of Bulgaria and Turkey, where an EU-investor could locate his servicing firm in Bulgaria due to the Europe Agreement rather than in the neighbouring developing country Turkey. But in practice, he may not be able to service the Turkish market from Bulgaria on account of import restrictions on services. Trade between the developing and EA-countries is more restricted than between the EA- and the EU-countries. Even in the absence of trade restrictions, an investor will, for example, not be able to substitute a tourist or trading branch in East Asia with one in Poland or Czech Republic. Thus, the international locational competition in tertiary sector generally does not exist. The importance of this sector in terms of its shares in total outflows of FDI from many EU-countries has increased over time [ibid., p. 316]. In France, Italy and the Netherlands, FDI in this sector accounts for more than half of all outflows. The same applies to Japan and the USA [OECD, 1993a]. In the Asian developing countries, for whom the sectoral data are readily available, foreign investments in services

amounted from one half to four fifths of all FDI inflows during the late 1980s in many cases [Agarwal et al., 1994, p. 370], documenting the limited chances of its diversion to the EA-countries.

The manufacturing sector can be divided into two segments for purposes of this analysis. The first and foremost segment includes industries in which FDI is lured by market size and growth, market proximity, and to avoid trade barriers and high transport costs involved in the case of exports. Market-based FDI in these industries of developing countries will most probably remain unaffected by the European Agreements. The second segment includes footloose manufacturing industries in which FDI in developing countries is motivated to take advantage of their lower unit costs of labour and/or environmental regulations. Examples of cost oriented FDI are found relatively more in textiles, clothing, leather and consumer electronics. Such investments have influenced the growth of free trade zones in many host developing countries. Nonetheless, the share of these investments in total stock of FDI is very small [UN, 1993] and it has steadily declined in the last decade [OECD, 1993a]. Therefore, the scope for FDI diversion stemming from Europe Agreements is quite limited. Survey results demonstrate that foreign investors in EA-countries are mostly motivated by domestic market potential and not by their low labour costs [OECD, 1993b]. Moreover, their cost advantage is likely to be eroded in the course of convergence of their economies towards EU income levels and environmental standards, and with the resumption of realistic exchange rates. This is likely to be a slow process, but unavoidable before these countries can change their status from associated to full members of the EU.

VII. CONCLUSIONS

The Europe Agreements mark a great change in economic relations between Western and Eastern Europe. The policy reversal from isolation to integration of the EA-countries in the European economy should facilitate the inflow of international equity capital into these countries. The examination of the data does reveal such a trend. The inflow of FDI will be further accelerated as the process of transformation and stabilisation gathers momentum in their economies.

The growth of FDI into the EA-countries has so far been fed by a positive supply response of investible funds to the increasing locational competition among countries. The opening of the EA-economies has mobilised additional capital from smaller entrepreneurs across the borders, their own expatriates in Western countries

such as Bata Company, and from MNCs acquiring state owned bigger local enterprises.

There is so far no evidence of any meaningful diversion of FDI from developing countries to the EA-countries. Also for the future, the scope for such an FDI diversion appears for two important reasons to be very limited. First, a sizeable portion of FDI in developing countries is in primary and tertiary sectors which are not prone to investment diversion. The same applies to investment in manufacturing activities targeting at local demand of consumers as well as producers. It is primarily in footloose labour and pollution intensive segments of international production where developing countries are likely to face additional locational competition as a result of the Europe Agreements. Second, even in these cases negative impact on developing countries' competitive strength for international equity capital may be blocked by rising costs of labour and environmental standards in the EA-countries. Relative costs of labour would rise in the course of economic growth, and resumption of realistic exchange rates in these countries. Environmental standards would have to be adjusted upwards to become full members of the EU. Moreover, upward movement of these costs in the EA-countries is likely to be quicker than in many developing countries.

Finally, economic growth in the EA-countries resulting from transformation and integration of their economies into the Single European Market would create additional demand also for goods supplied by developing countries, which would, in turn, lead to additional flow of FDI in these countries. Thus, the net result of investment creation and any eventual investment diversion may not be negative. The UN projections for the near future forecast a continued strong growth of FDI inflows in the developing regions.

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